GROUNDS UPON WHICH A BANK CAN REFUSE PAYMENT OF CERTIFIED CHECKS.

With the great increase in the use of certified checks, questions have arisen with reference to the power of the makers to stop payment on them after delivery and to the liability of the certifying bank to the holder of a certified check upon which the maker has stopped payment, and particularly with reference to the defenses which are available to the certifying bank.

It is well known that a bank will sometimes refuse to pay checks which it has certified when requested so to do by a favored customer, if suitably indemnified, thereby forcing the holder of the check to resort to his legal remedies. Frequently a maker of a check will ask the certifying bank to withhold payment upon the ground that the check was delivered in payment for merchandise sold upon fraudulent representations, or for merchandise which fails to conform with the quality agreed upon. In this class of cases the question is presented as to whether or not the bank is absolutely liable on its contract of certification, or whether the so-called equities, or personal defenses, which might be pleaded by the maker of the check, are available to the bank.

Although now firmly established as a part of our commercial machinery, certified checks have been used on a large scale only in recent times; by which it happens that the rules of law applicable to them have not been as completely developed as in the case of many other instruments known to the law merchant.

Section 325 of the Negotiable Instruments Law provides that "A check of itself does not operate as an assignment of any part of the funds to the credit of the drawer with the bank, and the bank is not liable to the holder unless and until it accepts or certifies the check."

It is well understood that a check is merely an order or direction given to a bank to pay money in accordance with the terms of the check, and that this order can be revoked at any time before payment. Under the above statute, however, if the bank accepts or certifies the check it becomes liable thereon.

If the bank does accept or certify what is its contract?

Section 323 of the Negotiable Instruments Law provides "Where a check is certified by the bank on which it is drawn the certification is equivalent to an acceptance."

Mr. Morse, in his work on "Banks and Banking," says:

> "After certification is complete, the bank is bound as a direct and original promissor to the payee; it and he are parties to a new contract upon which he has his right of action directly against the bank, without any regard whatsoever to its relations with the depositor or the state of the drawer's account either at the time of, or at any time after, the acceptance."

In *Merchants Bank* vs. *State Bank*, 10 Wall, 604, the Supreme Court of the United States said:

> "By the law merchant of this country, the certificate of the bank that a check is good is equivalent to acceptance. It implies that the check is drawn upon sufficient funds in the hands of the bank, that they have been set apart for its satisfaction, and that they shall be so applied whenever the check is presented for payment. It is an undertaking that the check is good then and shall continue good, and this agreement is as binding on the bank as its notes of circulation, a certificate of deposit payable to the order of the depositor, or any other obligation it can assume. The object of certifying a check, as regards both parties, is to enable the holder to use it as money."

Another writer has said that a certified check was a shorthand certificate of deposit. It has also been said that the acceptance is in itself a new and perfect contract between the depositor and the bank, superseding the previous peculiar rights of all parties, and that its technical operation is to transfer to the holder the drawer's right of action against the bank.

These statements of the nature of the contract which the bank enters into by certifying a check seem in some courts, however, to be applicable in their full meaning to only one of two possible cases. Both by the law merchant and by the statute some distinction seems to be made between the case in which a check is certified by a bank after its delivery and at the request of the payee, and the case in which it is certified by the bank before delivery and at the request of the maker.

Section 24 of the Negotiable Instruments Law provides that "Where the holder of a check procures it to be accepted or certified, the drawer and all endorsers are discharged from liability thereon."

While by statute and as a matter of theory the maker of a check is discharged from liability thereon if the payee, instead of demanding and obtaining payment, demands and receives a certification, and while as a matter of theory the maker should not be discharged from his obligation in case he procures the certification, it is not easy to see that the obligation of the bank to the payee should be materially different in the two cases.

When a bank certifies a check it makes a new contract. It thereby makes certain admissions and also agrees to pay the check when thereafter presented for payment. It is because of this agreement that a certified check is regarded as the equivalent of money and as being "as good as the bank."

Where the bank certifies a check after delivery at the request of the payee the authorities agree that it is absolutely liable upon its own contract to the same extent as it would be liable upon its own certificate of deposit issued to the payee.

Apparently the same rigid liability would be attached to the bank in some jurisdictions in case it certified the check before delivery and at the request of the maker. But in other jurisdictions, notably in New Jersey, there is a tendency toward permitting the certifying bank, in the latter case, to defend upon any ground which would be available to the maker, as for example, fraud in the transaction in which the check was given in payment.

The purpose of certification before delivery is to give added credit to a check, and it is likely that in most cases the payee will be found to have changed his position, relying upon the fact of certification. If the bank at the request of the maker can refuse to pay a check which it has so certified, and in an action brought against it alone upon its contract of certification can set up as a defense any of the so-called equities existing between the maker and the payee, the confidence now reposed in certified checks would be greatly impaired.

It seems to be well established, at least in many jurisdictions,

that the maker of a promissory note cannot defend himself in any action by the endorsee upon the ground that the endorsee fraudulently procured the endorsement to him in any case where payment by the maker would discharge his obligation to the payee. This would not mean that the payee of the note might not implead the payee in case the maker had notice of the fraud of the endorsee and was disposed to favor the payee.

The payee of a note who has endorsed it; the drawer of a draft which has been accepted and delivered to a third party; and the maker of a check which has been certified at his own request and delivered, are in a similar position. In each case he has become secondarily liable on the instrument. To permit the certifying bank, when alone sued by the payee, to set up as a defense equities alleged to exist in favor of the maker of the check which has been certified at the maker's request, merely because the maker continues to be liable upon the original debt, or upon the check itself, seems to be making an unnecessary and unsettling distinction.

The New Jersey case above referred to is *Times Square Automobile Co.* vs. *Rutherford National Bank*, 73 Atl., 479. In that case the defendant bank certified a check at the request of the payee but refused payment at the maker's request upon a claim that he had been defrauded by the plaintiff in the sale of an automobile. It is to be noted that the check was certified at the request of the payee. The court held that the bank was absolutely liable upon its certification because of that fact, but went on to say, by way of argument or dictum, that if the maker had procured the check to be certified before delivery to the payee, the fraud of the payee which induced the purchase of the automobile would have been available to the bank, because the maker was still liable for the debt. As that particular point was not at issue, this case is not entitled to be regarded as actually deciding it, but it seems to be considered as forecasting the final decision of the New Jersey court upon that particular point.

In *Blake* vs. *Hamilton Dime Savings Bank,* 87 N. E. (Ohio), 73, the court refused to permit the certifying bank to defend on the ground of fraud between two parties who bore to each

other the same legal relationship as the maker of a check certified at his request and the payee.

It would seem therefore that the courts are likely to be in disagreement upon this question; whereby it will be necessary for the payees of certified checks to exercise caution in all cases in which the possibility of disputes exists. If certified checks are to serve their full purpose and continue to circulate as the equivalent of cash, it seems reasonably clear that the dictum in the New Jersey cause should not be followed.

If a vendor, for example, refuses to complete a sale unless he receive cash or a certified check, it is fair to assume that he is actuated by each of two motives: first, by a desire to obtain the firm obligation of a bank, and second, by a desire to take the transaction out of the realm of possible litigation with the purchaser. With respect to both purposes he would be defeated if the bank can resort to any of the personal defenses that might be available to the maker.

From the point of view of the payee it would make no difference whether the check was certified at the request of the maker before delivery or at the request of the payee after delivery. In fact, in a large number of cases, it will undoubtedly be found that the maker procures certification before delivery, because he has been notified by the payee that a given transaction will not be closed unless either cash or a certified check is tendered; so that the maker might well be held to have been acting as the agent of the payee in procuring the certification. In any event it will appear in many cases that the payee has actually changed his position, relying upon the fact of certification and, as against the certifying bank, might well be regarded as the holder of the bank's promise in due course without reference to real or imaginary equities claimed to exist in favor of the maker.

In case the maker had been defrauded by the payee his position would be no worse than it would have been had he paid in cash instead of by a certified check, and it would seem that the credit now reposed in certified checks ought not to be impaired by casting doubt upon the absolute liability of the certifying bank under its contract.

Of course, if a check, which has been certified either before or after delivery, is transferred to a holder in due course the bank will not be permitted to set up any of the personal defenses, but, as above indicated, there is now a doubt in case a check certified before delivery is in the hands of the original payee. It might often be convenient for the payee to remove this doubt by presenting the check for recertification, for if recertified at his request the bank's liability would become absolute. As above suggested, banks will often refuse payment on both classes of certified checks so that litigation may be unavoidable. If the bank does refuse payment of its certified checks the question of course is, "What defenses are open to it?" At present the answer seems to be that as to the class of cases in which the bank certifies for the payee it has no defense which does not go to the actuality of contracts, but that in the other class of cases the rule is uncertain and, in some jurisdictions, the bank might be permitted to plead any defense which was available to the maker.

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